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# Residential Property Lettings New Rules – effective 6 April 2017

The restrictions on residential property interest will soon start to apply as the legislation introducing these changes is now fully in place.

**To whom does the interest relief restrictions apply?**

The main group affected are UK resident individuals that let residential properties in the UK or overseas. Other people affected are:

- non-UK resident individuals that let residential properties in the UK
- individuals who let such properties in partnership
- trustee or beneficiary of trusts liable for income tax on the property profits.

**Who won't be affected?**

UK and non-UK resident companies are not affected nor landlords of 'Furnished Holiday Lettings'.

**How do the restrictions work?**

From 6 April 2017, landlords will no longer be able to deduct all of their finance costs from their property income. They will instead receive a basic rate reduction from their income tax liability for these finance costs. Finance costs include mortgage interest, interest on loans to buy furnishings and fees incurred when taking out or repaying loans or mortgages.

The restriction will be phased in with 75% of finance costs being allowed in 2017/18, 50% in 2018/19, 25% in 2019/20 and be fully in place for 2020/21. The remaining finance costs for each year will be given as a basic rate tax reduction but can't create a tax refund.

Example 1 in the appendix below shows how the restrictions affect the tax payable over the next four tax years for an individual with mortgage interest which equals 40% of his rental income (after deduction of other tax allowable costs).

**How much extra tax will this mean?**

The additional amounts of tax arising will depend on the marginal rate of tax for the taxpayer. Basic rate taxpayers should not be substantively affected by the proposals. A higher rate taxpayer will, in principle, get 20% less relief for finance costs.

However the calculation method may mean that some taxpayers move into higher rate tax brackets. For example, individuals who consider themselves basic rate taxpayers as their total net income before deduction of income tax is below the higher rate threshold (£45,000 in 2017/18), may find that if interest is not fully deductible they would have total net income above the higher rate threshold.

Example 2 in the appendix below illustrates this effect.

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**Other thresholds to watch out for:**

The threshold from which Child Benefit is clawed back (may apply if 'adjusted net income' of a person with children is above £50,000).

The threshold from which personal allowances are reduced (applies if 'adjusted net income' is above £100,000).

The threshold over which an individual's pension annual allowance of £40,000 is tapered (applies if an individual's 'adjusted income' is more than £150,000).

**Highly geared property investments**

There are special points to note if mortgage interest costs are substantial in relation to rental income.

Example 3 in the appendix below illustrates an individual, Derek, who will have an effective 100% tax rate on his rental income in 2020/21 when the full extent of the interest restrictions come into play. This applies where interest is equal to 75% of Derek's property income after deduction of non-interest expenses.

If Derek's interest to income percentage is higher than this, he will find the position gets even worse as he will not get immediate tax relief at 20% on all his interest. Example 4 in the appendix below illustrates this further restriction.

**Is a property investment company the answer?**

The new rules on finance costs do not apply to companies so it may be more attractive for landlords to acquire their new property investments in a company. Corporation tax rates are low compared to personal tax rates and so more funds may be available for reinvestment in additional properties.

Historically, mortgage finance for a company investing in residential property has been more expensive and more difficult to obtain but there is evidence that banks are becoming more amenable to the concept of corporate ownership of such properties.

There are however other tax issues to consider when holding investments in a company which include:

- The income tax due on company profits being distributed to the shareholders.
- A potential double tier of capital gain on any sale of a property. Corporation tax is payable on the capital gain (although the gain is reduced by an inflation adjusted base cost of the property). Then, if the gain is distributed to shareholders as a dividend there would be an income tax charge on the dividend paid as well.
- The different treatment of the assets held by the individual on death may affect the tax paid on subsequent capital gains if the properties are eventually sold. If properties are held directly by an individual, inheritance tax (IHT) liabilities will be based on the value of the properties at death and the value of the properties are uplifted to market value for calculating future capital gains. If the individual has a property investment company, the shares in the property company are valued for IHT purposes at market value but the properties themselves remain at their original base cost.

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Transferring an existing property portfolio into a company requires even more careful consideration as it could result in capital gains and stamp duty liabilities arising on the transfer of the properties.

We would be happy to provide further advice on the impact of running a property investment company or any other aspect of the new rules.

If you have any queries over this article please contact Kay O'Reilly (Kay@cubepartners.com) or Jon Agness (jon@cubepartners.com) by email or by phone on 01604 758595.

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**APPENDIX – examples of the operation of the interest relief restrictions**

**Example 1** - how the restrictions affect the tax payable over the next four tax years

Annabel pays higher rate tax on all her income. Her net rental income before deduction of interest is £20,000. She has £8,000 of interest payments per year.

| **Tax year:** | **2016/17** | **2017/18** | **2018/19** | **2019/20** | **2020/21** |
|---|---|---|---|---|---|
| | **£** | **£** | **£** | **£** | **£** |
| Rental income | 20,000 | 20,000 | 20,000 | 20,000 | 20,000 |
| Less: Interest allowed as expense | 8,000 | 6,000 | 4,000 | 2,000 | - |
| Taxable profit | 12,000 | 14,000 | 16,000 | 18,000 | 20,000 |
| Tax at 40% | 4,800 | 5,600 | 6,400 | 7,200 | 8,000 |
| Less: credit | - | 400 | 800 | 1,200 | 1,600 |
| Net tax | 4,800 | 5,200 | 5,600 | 6,000 | 6,400 |
| Effective tax rate on net rental income of £12,000 | 40% | 43.3% | 46.7% | 50% | 53.3% |

**Example 2** - how basic rate taxpayers can become higher rate taxpayers

Consider the 2020/21 tax year when the transitional period is over. Assume that the personal allowance is £12,000 and the basic rate band is £38,000 meaning that the higher rate band starts at £50,000.

Brian has a salary of £35,000, rental income before interest of £23,000 and interest on the property mortgage of £8,000.

Under the current tax rules, taxable rental income is £15,000. He will not pay higher rate tax as his total income is £50,000 - the point from which higher rate tax is payable.

With the new rules, taxable rental income is £23,000 and so his total income is £58,000. £8,000 is taxable at 40% - £3,200. Interest relief is given on £8,000 at 20% - £1,600. So an extra £1,600 tax is payable.

**Example 3** - an individual with high interest costs relative to rental income

Derek pays higher rate tax on all his income. His net rental income before deduction of interest is £20,000. He has £15,000 of interest payments per year.

| **Tax year:** | **2016/17** | **2020/21** |
|---|---|---|
| | **£** | **£** |
| Rental income | 20,000 | 20,000 |
| Less: Interest allowed as expense | 15,000 | - |
| Taxable profit | 5,000 | 20,000 |
| Tax at 40% | 2,000 | 8,000 |
| Less: credit (20% of £15,000) | - | 3,000 |
| Net tax | 2,000 | 5,000 |
| Effective tax rate on net rental income of £5,000 | 40% | 100% |

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**Example 4** – an individual making a loss but taxed on a 'profit'

Relief for finance costs may be restricted further where either of the following are less than the restricted finance costs:

- Property profits - the profits of the property business in the tax year (after using any brought forward losses)

- Adjusted total income - the income (after losses and reliefs, and excluding savings and dividends income) that exceeds an individual's personal allowance.

For example, Derek in 2020/21 replaces a fitted kitchen on one of the properties and much of this expenditure qualifies as repair expenditure and is tax deductible. His net property income falls to £13,500 before interest of £15,000. He has therefore made a £1,500 loss.

Despite recording a loss the £13,500 is taxable. Tax at 40% is £5,400. Some relief for the interest is given but is restricted to £13,500 at 20% rather than £15,000 at 20%. The unrelieved interest (£1,500) is carried forward and may get tax relief in a later year.

So the tax liability is £5,400 less £2,700 (£13,500 at 20%) = £2,700.